Internal Revenue Service
memorandum

CC:FS:TL-N-304-92
CORP:LEGardner

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to: District Counsel, San Diego CC:SD
Attn: June Bass

from: Assistant Chief Counsel (Field Service) CC:FS

subject: [redacted]

This is a written response to your request for Field Service Advice.

ISSUE

Whether the SRLY limitation on "built-in losses" limits the amount of net operating loss carryover that [redacted], can contribute for use by its parent, [redacted], with respect to NOL's which were acquired from [redacted] and [redacted], as a result of their mergers on separate dates into [redacted].

CONCLUSION

We conclude that the SRLY limitation on net operating loss carryovers, Treas. Reg. § 1.1502-21(c)(1), limits the amount of the net operating loss carryover that [redacted], can contribute for use by its parent, [redacted], with respect to NOL's which were acquired from [redacted] and [redacted]. We note that this conclusion is based upon the facts as presented in your request and as presented in a private letter ruling which discussed one of the transactions involved in this case.

FACTS

[redacted], (Parent) was a [redacted] chartered stock savings bank. Parent acquired [redacted], (Acquiring) in [redacted]. Upon this acquisition, parent became a savings and loan holding company. Parent and its subsidiaries filed a calendar year consolidated Federal income tax return. Acquiring was a Federally chartered stock savings bank.

On [redacted], [redacted] ([redacted]) and its subsidiaries were merged into Acquiring, pursuant to

section 368(a)(1)(G). At the time of the merger, [redacted] had accrued NOL's of approximately $[redacted]. These NOL's were accrued in [redacted], [redacted], and [redacted]. On the consolidated group's [redacted] income tax return, [redacted] carried over the NOL's acquired due to the merger.

[redacted] (Target), was a Federally chartered mutual savings bank. Target and its subsidiaries filed a fiscal consolidated Federal income tax return. In order to expand operations of Acquiring and Target, achieve operating economies, and permit more effective service of the financial needs of their customers, the Board of Trustees of Target and the boards of directors of Parent and Acquiring adopted an Agreement and Plan of Reorganization (the Plan) whereby Target merged with and into Acquiring. Following the merger, the separate identity of Target ceased and all voting rights in Target expired. On [redacted], Target was merged into Acquiring, pursuant to section 368(a)(1)(A). At the time of the merger, Target had accrued NOL's of approximately $[redacted]. These NOL's were accrued in [redacted], [redacted], [redacted], and [redacted]. On the consolidated group's [redacted] income tax return, Acquiring carried over the NOL's acquired due to the merger.

DISCUSSION

All references to the Internal Revenue Code apply to the Code edition for the year in issue.

In Wolter v. Commissioner, 80-2 USTC § 9799, the issue was whether deductions claimed on a consolidated income tax return by a parent corporation and its controlled subsidiary corporation, with respect to net operating losses sustained by the subsidiary in years prior to its affiliation with the parent, were allowable as net operating loss carryovers when the subsidiary had no post-consolidation income for the tax years in question. One of the taxpayer's arguments was that the separate return limitation year (SRLY) regulations are invalid to the extent the regulations prohibited the carryforward of the net operating losses from separate return limitation years. The United States Court of Appeals for the Sixth Circuit, in affirming the Tax Court opinion in 68 T.C. 39 (1977), held that the affiliated group was not permitted deductions for carryovers of preaffiliation net operating losses incurred by the subsidiary. In so holding, the Tax Court and the Sixth Circuit concluded that the SRLY regulations, which are legislative in character, are valid.

The following discussion applies the SRLY regulations to this case. Generally, the taxable income of a consolidated group is determined by aggregating the income and losses of each member of the group. This approach reflects the "entity" concept of the consolidated group. An exception to the entity approach applies in the case of losses incurred by group members in taxable years

in which they did not join in the filing of a consolidated return, which are carried forward or backward to consolidated return years. In such a situation, the separate return limitation year (SRLY) rules limit the use of such losses by the group.

The theory underlying the SRLY rules is that the carryover of net operating losses (NOL's) generated in a separate return year should only be usable to the extent that the losses could have been used to offset taxable income if the member generating the losses had filed a separate return for the carryover or carryback year. The SRLY limitation for the years at issue is applied on a member-by-member basis. A NOL of a member of the group or a predecessor of a member that arose in a separate return limitation year of the loss member cannot be used to offset consolidated taxable income attributable to other members of the group. Treas. Reg. § 1.1502-21(c). A similar limitation applies to the use of built-in deductions that economically accrued in a separate return limitation year and are recognized in a separate return year that is not also a separate return limitation year. Treas. Reg. § 1.1502-15(a)(2).

The term "group" means an affiliated group of corporations as defined in section 1504. Treas. Reg. § 1.1502-1(a). The term "member" means a corporation which is included within an affiliated group. Treas. Reg. § 1.1502-1(b). A separate return year is "a taxable year of a corporation for which it files a separate return or for which it joins in the filing of a consolidated return by another group." Treas. Reg. § 1.1502-1(e). A separate return limitation year is "any separate return year of a member or of a predecessor of such member." Treas. Reg. § 1.1502-1(f)(1), subject to exceptions. One of the exceptions is that a separate return limitation year shall not include a separate return year of any corporation, or generally its predecessor, which was a member of the group for each day of the taxable year. Treas. Reg. § 1.1502-1(f)(2)(ii) and (iii). A predecessor is defined as "a transferor or distributor of assets to a member in a transaction to which section 381(a) applies." Treas. Reg. § 1.1502-1(f).

Section 381(a) provides that:

> In the case of the acquisition of assets of a corporation by another corporation-- * * * (2) in a transfer to which section 361 * * * applies, but only if the transfer is in connection with a reorganization described in subparagraph (A), (C), (D), (F), or (G) of section 368(a)(1), the acquiring corporation shall succeed to and take into account, * * *, the items described in subsection (c) of the distributor or transferor corporation, subject to the conditions and limitations specified in subsection (b) and (c) * * *.

Section 381(c)(1) lists one of the items of the transferor corporation as net operating loss carryovers determined under section 172.

Section 381 prescribes rules that govern the carry over of, or succession to, specific tax attributes following certain corporate transactions. Section 381(a) confers the right to pass these tax attributes to another corporation. In certain acquisitions of the assets of another corporation, the acquiring corporation succeeds to the NOL carryovers of the acquired corporation. The transfer must be one in which section 361 applies to the acquired corporation's exchange of property for stock.

Section 361(a) provides that:

> No gain or loss shall be recognized to a transferor corporation which is a party to a reorganization on any exchange of property pursuant to the plan of reorganization.

Pursuant to section 368(b), a party to a reorganization includes "both corporations in the case of a reorganization resulting from the acquisition by one corporation of stock or properties of another." Both Target and Acquiring are parties to the reorganization in this case. There was an exchange of property pursuant to a plan of reorganization. Therefore, the transaction was one in which section 361 applies.

The other requirement of section 381 is that the transfer must be in connection with an (A), (C), (D), (F), or (G) section 368(a)(1) reorganization. Section 381(a)(2), in part, permits the transferor's NOL's to be carried over if its assets are acquired as result of (i) a statutory merger or consolidation (section 368(a)(1)(A)), (ii) a bankruptcy reorganization transfer in a Title 11 or similar case (section 368(a)(1)(G)). In the instant case, one transaction has been characterized as a merger qualifying under section 368(a)(1)(A), and the other transaction has been characterized as a merger qualifying under section 368(a)(1)(G). These characterizations have not been disputed by you. Therefore, the requirements of section 381 are met and the NOL's carry overs are allowed by that section as determined under section 172, but subject to the limitations imposed by sections 381(c) and 382. Since section 381(a) applies, we can conclude that [redacted] and [redacted] qualify as predecessors pursuant to Treas. Reg. § 1.1502-1(f). They were transferors of assets to a member of the [redacted] group in a transaction to which section 381(a) applied.

According to the facts presented, both predecessors either filed separate returns or joined in filing consolidated returns

with another consolidated group and were not members of the [redacted] group for any day of the separate return years. Thus, the years prior to each merger are separate return limitation years. The NOL's arose in the separate return limitation years of [redacted] and [redacted], predecessors of the member, Acquiring. Therefore, under Treas. Reg. § 1.1502-21(c), we conclude that the consolidated net operating loss carryovers of the group shall be limited by the rules set forth in Treas. Reg. § 1.1502-21(c). Further limitations may be imposed by section 382 on the amount of the NOL carryover that can be used to offset against the successor entity's income. You have not asked any question as to this limitation and therefore we do not address in this memorandum to what extent section 382 limitations may be applicable.

Your statement of the issue refers to the SRLY limitation on "built-in" deductions. The "built in" deduction rules set forth in Treas. Reg. § 1.1502-15 not only applies a SRLY limitation to built-in deductions, but also contains certain ordering rules that do not apply under a direct appliaction of the SRLY rules of Treas. Reg. § 1.1502-21(c). Since the application of the built-in deduction rules can produce different results than a direct application of the SRLY rules of Treas. Reg. § 1.1502-21(c), it is necessary to determine whether the built-in deduction rules are applicable. The rules for the application of the built-in deduction rules to NOL carryovers only apply in a very narrow case. Treas. Reg. § 1.1502-15(a)(2), provides, in part, that

> built-in deductions are deductions or losses of a corporation which are recognized in a separate return year and carried over in the form of a net operating or net capital loss to such year, but which are economically accrued in a separate return limitation year (as defined in § 1.1502-1(f)).

Under Treas. Reg. § 1.1502-15(a), in order for the limitation to apply under this section, the built-in loss must be recognized in a separate return year (which is not also a separate return limitation year) while the built-in loss must be economically accrued in a separate return limitation year. In the instant case, although the issue statement refers to built-in losses, we do not believe that the built-in losses rules are applicable. That is, we do not believe that the special application of the built-in deduction rule to NOL carryovers is applicable to this case. In the instant case all tax years prior to each merger were separate return limitation years. That is, neither of the transferor (acquired) corporations were part of the affiliated group in question during the years prior to these mergers. Therefore, the NOL's at issue were all recognized (as well as economically accrued) in years which were separate return limitation years and therefore such losses were not recognized in

a mere separate return year (i.e., a nonconsolidated return year in which the corporation was part of the affiliated group). As such, the rules under Treas. Reg. § 1.1502-15 are not applicable.

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If you have any questions regarding this matter, please contact Lorraine E. Gardner at (FTS) 566-3335.

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